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Frank presentation of ominous facts was never more necessary than it is today because we seem to have developed escapism into a system of thought… This leads to the charge of "defeatism." I deny entirely that this term is applicable to an analysis. Facts in themselves and inferences from them can never be defeatist. The report that a given ship is sinking is not defeatist. Only the spirit in which this is received can be. The crew can sit down and drink. But it can also rush to the pump. If the men merely deny the report though it is carefully substantiated, then they are escapists… This is one of those situations in which optimism is nothing but a form of defection.

Joseph A. Schumpeter, *Capitalism, Socialism and Democracy,* 1956

I have never seen so much baloney, nonsense and pure BS coming out of Wall Street, its analysts and strategists, as I have seen at present. And unfortunately, the press does not have sophisticated analysts or market experts doing the stories that we read in the newspapers and magazines.

Richard Russell, *Dow Theory Letters*, Dec. 12, 2001

PROFITS CRISIS

Entering the New Year, two paramount questions loom over the $10 billion U.S. economy: Was the proclaimed new paradigm economy with its alleged productivity and profit miracles for real, holding the promise of a bright future in the long run? Or was it an evil, Japanese-style "bubble economy," propelled and badly maladjusted by the most prodigious credit and debt excesses in history, heralding now a protracted, unusually severe recession? A bubble economy implies by definition that skyrocketing asset prices have prompted immoderate borrowing and spending binges in consumption and/or capital investment. To be sure, the first dictum is the overwhelming consensus view; the second one is our own view shared by a few other people.

Observing the U.S. economy's abrupt slide from a growth rate of 5.7% in the second quarter of 2000 to –1.3% in the third quarter of 2001, annualized rates, associated with the worst profits slump in U.S. postwar history, we thought for a while that this might crack, if not shatter, the euphoria about the alleged New Economy wonders. Measured consumer and business confidence have come down, but in relation to current miserable conditions, expectations appear more ludicrous than ever.

Everybody talks about the U.S. economy's impending recovery. But literally nobody bothers to substantiate this forecast by explaining how it will come about. Instead of their brain, they use their fingers, telling us that postwar recessions have lasted on average 11 months. Since this one already has nine months behind it, recovery is simply overdue, according to this predominating logic.

Even before this recession began, we have continually warned of the economy's unusually poor profit performance during the prior boom years. As the economy sharply slowed during 2001, it turned into a virtual profit implosion. Profit margins are at their lowest since the Depression in the 1930s. Moreover, there is nothing in sight that might reverse this progressive profit erosion. A careful, comprehensive analysis of potential profit sources leads to the conclusion that the profit-depressing influences remain in full force. While policymakers and economists may fail or refuse to recognize this ugly reality, the CEOs have capitulated willy-nilly to the profits disaster. Their predictable solution has been and will remain a savage curtailment of their investment spending. This, in turn, is progressively curbing employment, consumer incomes and consumer spending.

The great hope among the recovery forecasters is that the spendthrift consumer will rescue the U.S. economy from a deepening recession by maintaining his borrowing and spending binge. The key assumption is that his finances remain in excellent shape because the remaining gains in market values of stocks and homes still vastly offset the steep rise of his indebtedness. Besides, hopes are riding high that a new, liquidity-driven bull run of the stock market will help to boost the economy. The return of the bubble, in other words, is their hope.

Our analysis of actual and potential profit sources leads us to the opposite conclusion: The worst part of the bear market in stocks is still before us, and it will essentially involve the wholesale destruction of the pseudo-financial wealth that the bubble economy has created in the past years. Relative to profits, U.S. stocks today are even more overvalued than at their peak in April 2000.

RECOVERY MIRAGE

Currently, one question about the U.S. economy is the most acute and most probably also of crucial, climatic importance. That is, whether or not the widely predicted and expected imminent recovery will truly materialize. Although its start has been steadily postponed, this has apparently not impaired the still deep-seated, long-term optimism about the U.S. economy at all.

Oddly, overall confidence even seems to have risen since the Sept. 11 terrorist attacks. Consumer confidence has strongly picked up, and the stock market has staged a prolonged, sharp rally. Together with some improvements in the data, all this has been readily interpreted as the first signs of the expected recovery. It is conveniently overlooked that the terrorist attacks essentially caused temporary distortions. Some spending has been pushed back from the third quarter to the fourth quarter. Therefore, there is reason to assume that some better data since October 2001 largely reflect dissipating shock effects. At the same time, corporations have pulled forward sales from the first quarter by aggressive price discounting and financing deals, apparently not just in the auto sector. Meanwhile, the economy's broad, longer-term weakness continues as before the attack.

For most economists and the broad public, the U.S. economic outlook remains bright. The recession is called the mildest in history. It disturbs nobody that their earlier predictions were dead wrong. A year ago, in December 2000, 54 forecasters surveyed by *Business Week* had predicted, on average, that U.S. real GDP would grow by 3.1% in 2001. Until the Sept. 11 attacks, the consensus was sure that a recession in the United States was impossible. According to the Business Cycle Dating Committee at the National Bureau of Economic Research, the U.S. recession began in March 2000.

Now the recovery is supposed to start, at the latest, in this year's second quarter. For the year as a whole, real GDP will grow 2.5%, hitting a growth rate of 3.4% in the fourth quarter. This is the average expectation of 59 economists surveyed by *Business Week* in December 2001. Looking for some explanation, we read in *Business Week* (Dec. 10, 2001): *"The downturns since World War II have ranged between 6 and 18 months, with an average of 11. This one is now nine months old. The recession would be the longest in the postwar era for recovery to be delayed past the middle of 2002. That's unlikely because the policy response during the slump has been far faster and larger than average."*

THE KEY CHECKMATE: PROFITS

In contrast to the optimistic consensus, we have kept warning that the U.S. economy is heading for a protracted, unusually severe recession. Mainly two considerations make us dead sure about this: One is the accumulated outsized imbalances and excesses in the economy that need substantial adjustment before the economy can return to normal growth; and the other one is the prolonged, miserable profit performance. Observing that this poor profit performance started while the economy was still booming, this essentially raises disturbing questions about its underlying causes, and whether or not these causes remain virulent. Our

categorical answer: these causes prevail because they are of long-term structural nature.

While Wall Street, the corporations and Fed Chairman Alan Greenspan have been trumpeting an unfolding profit miracle that they ascribed to unprecedented productivity wonders arising both from the new information technology and America's new corporate equity culture, we have been emphasizing the exact opposite conclusion that the influence of these two major changes in the U.S. economy were grossly misjudged. Instead of improving profits, they would implicitly demolish them. And just that has happened.

The "profit miracle" that Wall Street and everybody else have celebrated during the last few years took place solely in the heavily crooked figures that the individual companies report. In contrast, the government's national income statistics continually revealed a profit performance that compared rather poorly with past cycles. Drastic revisions in these statistics, published in July 2001, have meanwhile confirmed that the profit performance was in reality a lot worse than mediocre. It was the worst in any boom period.

When the economy sharply slowed in the course of 2001, the poor profit performance turned into an outright profit disaster. Firms slashing their investments and private households that stopped to dissave are the major negative influences on profits. Third-quarter pre-tax profits of nonfinancial firms in the third quarter were $381 billion, well below their level of $403.8 billion in 1995. After-tax profits over these years are down from $323.9 billion to $241.7 billion. Since early 2001, dividends are increasingly paid out of borrowed money, accounting in the third quarter of last year for $78 billion of a total $320 billion, annualized, dividend payments. The high-tech sector contributed an aggregate net loss of $9.2 billion.

A MONEY AND CREDIT DELUGE…

This unprecedented profits carnage is really the most ominous feature of the U.S. economy's present downturn. Equally unprecedented and ominous is something else: the fact that this recession has occurred in the face of the most rampant money and credit deluge in history.

All prior recessions were initiated by the tightening of credit, implemented by the Federal Reserve in response to rising inflation rates. Tighter credit forced consumers and businesses to curtail their spending. In turn, once the Fed removed the credit shackles, spending jumped back to its former upward trend.

For the bullish consensus, ironically, the skyrocketing money growth is one of the few straws at which they are clutching as the probable harbinger of the economy's impending recovery. Broad money (M3) over the last year has expanded by about one trillion dollars, or 13.5%. In their view, such massive creation of liquidity simply cannot fail to lift the economy and the stock market. Our answer, in short, is: It won't because most of this liquidity is unable to do so. Let us explain.

Looking at the M3 money aggregate, we must distinguish between two sources of its creation. One is bank lending. The other one is flows into money market funds. Every new bank loan increases the volume of bank deposits. These come into being as the borrower utilizes the new bank credit for spending. The recipient of his payments registers a corresponding increase in his bank deposits. In this way, the loans of one bank generate the deposits of others. When a bank buys securities, the same result happens with their seller.

But in the United States this kind of money creation through bank lending has dramatically slowed down. In fact, it has virtually stopped. During 2001, total loans and leases of the banking system increased by merely $50.5 billion, or 1.3%. Commercial and industrial loans shrank $62.6 billion, or 5.7%. Most of the rise of total assets by $190 billion came from bond purchases. Banks' deposit liabilities, on the other hand, grew $360 billion. But among them were just $4 billion transaction deposits.

These numbers say that the banking system accounted for little more than one-third of last year's M3 growth. Almost two-thirds of the increase arose from flows into the money market funds. These funds are counted as money supply because, like bank deposits, they are highly liquid assets for their owners.

…WITHOUT VISIBLE EFFECTS

But while they appear to be equal in this respect, there are tremendous differences in the way the two money aggregates are created and how they can be used. The person or institutions acquiring a deposit at a money market fund inherently transmits a corresponding amount from his bank deposits to the account of the money fund that will now dispose. For liquidity reasons, it will buy highly liquid credit papers of first-class debtors. The most favored asset last year was government-sponsored agency bonds.

The crucial point to see now is that deposits at money market funds represent no means of payment for their owners. Only the bank deposits that they have transferred into the ownership of the money market fund are. But their use for the money market funds is strictly limited to the purchase of liquid credit paper. Owing to this strict limitation to their choice of investment, there exists no direct link between the money market funds and the economy or the stock market. It is really money that is locked into the bond market. If the owner of such funds wants to spend a part of them, he has to covert a corresponding amount back into bank deposits.

What, actually, irks us rather more than the money numbers are the even more fantastic credit numbers. During the third quarter of 2001, credit growth on the part of the nonfinancial sector was running at an annual rate of $1,275.5 billion and that on the part of the financial sector at another $1,086.3 billion. All this debt creation, running together at an annual rate of more than $2.3 trillion, created negative real GDP growth of $31.3 billion. It is hard to imagine something that appears more disastrous for an economy. It keeps us wondering where all that borrowed money has gone. Essentially, its main outlet must have been the financial markets.

With these differences in the source of money creation in mind, we regard the weakness in money creation through bank lending as a very important negative for the economy because this is chiefly the money that circulates in the economy. At the same time, the apparent reluctance of banks to lend may be a telltale sign of their risk perception.

What about the failure of the Fed's aggressive easing to show any visible effect on the economy? It has now been more than 13 months since its first rate cut, and yet reliable signs of the predicted recovery still remain missing. Considering that past recessions have averaged only 11 months, this lag in impacting the economy is definitely already unusually long. But like many other extremely negative things, it is flatly ignored. It is even ignored that the Fed's many rate cuts have miserably failed to have their normal stimulative effects on the financial system, signaling an early warning that the Fed's easing is being frustrated by the markets.

True, it takes time for monetary easing to impact the economy. There is many a slip between the cup and the lip. Actually, the rate cuts by a central bank effectively impact the economy through prior effects on the financial system. As short-term rates fall, investors move out of money and into equities and higher-yielding longer-term bonds, boosting their prices and thereby also lowering the long-term rates. At the same time, capital flows out of the country and lowers its currency. But the problem in the present U.S. case is that these three financial effects that are vitally important for the effectiveness of monetary policy have completely failed to materialize. Observing this monetary failure is one of the main reasons why we flatly refuse to believe in the recovery forecasts.

CONSUMER ILLUSIONS

But our pessimism in this respect has more reasons than that. Above all, we radically disagree with the consensus view that the debt-laden consumer is able and prone to rescue the U.S. economy from a deepening recession, if not to spark a recovery. First of all, the rosy picture of a super-resilient consumer needs considerable correction.

In reality the consumer has drastically retrenched. In early 2000, his spending grew at an annualized rate of 5.9%. By the third quarter of 2001, the gain was barely 1%, and it occurred largely in essentials, like housing

and medical care. His contribution to real GDP growth has effectively plummeted from 3.28 percentage points in 2000 to 0.67 percentage points in the third quarter of 2001. The inherent drag on GDP growth of 2.61 percentage points was, actually, bigger than the drag from business fixed capital investment (2.33 percentage points).

It is widely hailed that consumer confidence surveys indicate great optimism on his part about the future. We have to say that we regard the results of such surveys as complete rubbish. The consumer just echoes what the media and all the experts are unanimously telling him. Don't worry: recovery is around the corner. His illusions reflect the illusions of the experts. As to the quality of their optimistic forecasts, Richard Russell has said it all: *"These economists offer baloney and nonsense as never before, moving simply in a pack. Serious, independent analysis is a rarity."*

On closer look at the American consumer's finances, we can only conclude, on our part, that he is manifestly financially tapped out. Not only does he have record-high debts behind him and stagnant income before him, he also has two frightening danger spots in his financial outfit: near-zero savings out of current income and assets (stocks and homes) with bubble-like market valuations. For us, it is a most frightening thought that the fate of the U.S. economy depends on the preservation of grossly inflated stock values.

There is still another point that greatly intrigues us about the consumer and his finances. His spending effectively increased in the third quarter of 2001 by an amount of merely $15.5 billion. But while his spending was sharply down, he borrowed another $616 billion at annual rate in the same quarter. We are at a loss to say where all that money went. Yet we are sure of one thing: this is definitely not a sustainable borrowing and spending pattern.

High on the list of the sectors that typically lead the economy out of recession is homebuilding. Being largely credit-financed, in recessions of old it has regularly plummeted when the central bank tightened the credit spigot. The same, by the way, is true of consumer buying of durables. Once the Fed loosened its shackles from the credit machine, the two interest-sensitive sectors rebounded dramatically, importantly propelling the ensuing recovery.

It cannot and will not happen this time. In the absence of any monetary tightening, housing and vehicle sales were effectively spared their usual sharp downturn. Doing so, they have cushioned the downturn, but this has a troubling flip side: The two have little or no upside potential from their given record-levels for a long time to come, even with the easiest and loosest money.

But hasn't the impetuous response to Detroit's "zero-financing" campaign proved the consumer's willingness and ability to spend when he sees a bargain? First of all, there has been more excitement about this action than economic effects. For the economy as a whole, this spending was a drop in the bucket. Second, it is the kind of bargain that ruins the producers if applied more extensively. And third, considering the prolonged stagnation and even decline of consumer incomes, such actions don't increase overall demand; they borrow from future demand to be followed by a sharp fallback in vehicle sales in the not-so-distant future. To hail this as a precursor of the predicted recovery is just ridiculous. Yet it helps for a while to give false evidence of a rebounding economy. Consider that the one-off auto sales binge will enter the GDP accounts of the fourth quarter at an annualized rate.

IT IS TRULY DIFFERENT THIS TIME

To repeat again: This downturn of the U.S. economy is of entirely different character than all its predecessors in the whole postwar period. Implicitly, this says that past experience has little or no value as a clue for the future. It may even be grossly misleading. But reading many reports forecasting the U.S. economy's imminent recovery, we notice with amazement an overwhelming inclination among American economists simply to look for typical sequences that happened in connection with past recessions.

Take the stock market rally that started after the terrorist shock. The fact that stock indexes increased by more than 20% from their low on Sept. 22 was immediately hailed as further compelling proof of the arrival of the new bull market that, in turn, was readily interpreted as a strong confirmation of the predicted economic

recovery. No deeper analysis of underlying factors that speak for or against a sustained rally was offered. Focusing on the foreseeable, miserable profit prospects, it was clear to us that this was a sucker's rally.

Another striking example of a misleading indicator has been the steeply sloped yield curve, reflecting the difference between the yields of short-term and long-term government bonds. This curve, in fact, is a component of the Commerce Department's leading indicator. It is typically argued that steep yield curves in the past have always accurately predicted a recovery.

It reminds us of a remark by Friedrich Hayek that the practical value of statistical research depends primarily upon the soundness of the theoretical conception upon which it is based. A little thinking about the way steep yield curves come about and why they have regularly preceded recoveries strongly suggests that this assessment makes no sense at all. The steepening of the yield curve arises regularly and automatically because the decline of long-term market rates inherently lags the decline of short-term rates that the central bank arbitrarily sets. As to the observation that a steep yield has always accurately predicted a recovery, the obvious explanation is the fact that all past recessions were promptly followed by a strong recovery.

THE FED'S DECISIVE FAILURE

What's more, for the effectiveness of monetary easing, it is crucially important that the falling short-term rates promptly pull long-term market rates downward, flattening the yield curve again. But in contrast to normal experience, this has completely failed this time, even though the Fed has been unusually aggressive in its rate cuts. Manifestly, this is a most important policy failure.

Nor has the Fed's regular magic worked in the stock market. From Ned Davis Research we learn that since the 1920s there have been 18 occasions in which the Fed cut interest rates twice in succession. On average, the Dow was 11% higher six months after the second rate cut and 23% higher on average a year later. Therefore the famous Wall Street mantra: Don't fight the Fed.

There were only two exceptions: 1930 and 1981. A third exception happened just last year in the face of the 11 rate cuts that have taken place at unprecedented speed. For the year, the Dow was down 6%, the S&P has fallen 12% and the Nasdaq, its fourth-quarter fireworks notwithstanding, has plummeted 19%. As Goldman Sachs points out, considering the fall in stock prices, the rise in long-term rates and the irrepressible dollar, broad financial conditions in the United States have hardly loosened during the last year.

Looking into the history books, the striking parallels are definitely between 1930 and 2001. In both years, U.S. monetary policy had to cope with the aftermath of a burst bubble economy. It occurs in a two-stage process. The first stage is the bursting of the bubble; the second stage involves the prolonged, painful crisis adjustment processes both of structures and values to sustainable norms. In October/November 1929, when the Wall Street bubble burst, the Dow declined 47.9% in just two-and-a-half months. After the crash, the index rallied 48% into a secondary top (lower high) in April 1930. In addition to the deep oversold conditions resulting from the crash, drastic Fed easing had succeeded in fuelling the rebound of the stock market. In total, the slump of the DJIA for the bear market from September 1929 to July 1932 was 89.2%.

Manifestly, the most devastating part of the bear market in the 1930s was not the crash but the following, painful post-crash economic and financial adjustment processes. Presently, the necessary downward adjustment of consumer spending to available and sustainable current income has not even started.

We do not necessarily expect an equally severe bear market as in the 1930s. However, we are absolutely sure that the big crash in U.S. stocks has yet to happen. Current stock valuations are ridiculously high even though the S&P is still about 25% below its all-time peak; the Nasdaq is down 60%. These are steep falls, but since corporate earnings have fared a lot worse, price-to-earnings ratios have soared to new record levels. Compared to a year ago, the ratio for the Dow is up from 20.52 to 28, for the S&P 500 from 24.50 to 40.70, for

the S&P Industrial from 26.3 to 52.80, and for the Dow Jones Utility Average from 20.41 to 45.9. Absurdly, stocks are more expensive than ever.

NOT ALL MONEY IS MONEY

How to explain this amazing new surge in stock prices? To quote Joseph A. Schumpeter: *"Since stock prices confront a public very much more excitable and very much less intelligent than the constituent individuals are in their ordinary business pursuit, it is tempting to stress mere mass psychology, on the one hand, and mere abundance of funds, on the other."*

The notorious bulls have one main argument. Actually, it is the only one that seems to make any sense: In their view, the bull run of the stock market since Sept. 22 is essentially liquidity-driven. Thanks to Mr. Greenspan, the economy appears to be drowning in "excess money." M3, as already mentioned, has been expanding by 13.5% for more than 12 months. The term "excess money" relates to money growth in excess of nominal GDP growth. Measured by M3, this excess has been at its highest in history. Just as bizarre, of course, is the coincidence of a skyrocketing money supply and a bear market in stocks.

We come to another crucial difference between our approach and that of the American consensus economists in assessing the rampant money growth. They see a tremendous accumulation of excess liquidity behind the recorded rampant money growth that will sooner or later pour into the stock market and the economy. For them, the persistent, massive money creation in excess of GDP growth is a great positive, importantly heralding the "V-shaped" recovery they predict. It also nicely fits their view that monetary easing works with long lags. Quite a few are therefore warning of coming inflation.

Our approach is radically different. What we see is the most unusual pattern of relationship between money growth and economic activity in history. Prolonged, rampant money and credit creation is showing no visible effects on the economy and the financial markets. For us, this is among the most worrying features of the present economic development in the United States. Observing far more credit and debt creation than money creation, we see rampant creation of illiquidity.

CREDIT QUANTITY VERSUS QUALITY

Old rules of the effects of money growth on the economy and the financial markets have plainly broken down. Is this just ephemeral, or could it have lasting, deeper-seated causes? And what are the causes? Are they in the process of money and credit creation or in a sharply reduced responsiveness of the economy?

For the consensus economists there is nothing wrong with this development. They see no more than a normal lag between monetary easing and its effects on economic activity. Some even seem to think the longer the lag, the stronger the later burst of spending. Speaking of normal lags, they confuse money and credit creation with monetary easing, embodied in the central bank's rate cuts. These rate cuts work, indeed, with a lag, but current money and credit creation implicitly reflects current borrowing that finances current spending with immediate effects on economic activity. If that fails to happen, as it has over the last year in the United States, you can be sure that there is something very wrong with the economy and the credit machine.

What could make for such extremely divergent effects of given money and credit creation? Here is Schumpeter's answer: *"Credit creation does not produce economically determined effects. These are contingent upon the use to which the newly created credit is applied and the way they take through the economic organism."*

For monetarists, the only thing that counts about money creation is its quantity. For the old economists, in contrast, the effects of credit creation were not simply or primarily a question of quantity, but mainly depend on the purposes which it serves. The only desirable purpose, in their view, was capital investment. This view had two main reasons. One is that capital expenditure in all specifications is the one and only kind of spending that

is self-financing; and the other one is that it has much larger effects on output than current government or consumer expenditure.

It keeps amazing us how little attention it is finding that the U.S. economy has been sliding into recession in the face of this rampant money and credit expansion. This has no precedent in history, and moreover it is very difficult to understand. In essence, it implies that the whole current money and credit creation is directed toward purposes that do not increase GDP. Its main purpose is therefore self-evident: all kinds of financial speculation and leverage. Other big credit absorbers that add nothing to GDP are the trade deficit and compound interest.

In terms of mere quantity of money and credit creation, the U.S. financial system is definitely by far the most efficient in the world. But in terms of quality of money and credit creation, it is just as definitely the worst in the world. Unlike the past and unlike the practice in the rest of the world, the emphasis of the financial system is not upon the economy's capital development, but rather upon the quick turn of the financial speculator. Credit availability for this purpose has no limit in America. The all-important point to see here is that virtually all of the current, rampant money and credit creation is absorbed by the grossly overexpanding financial system.

THE TYPICAL INVESTMENT PATTERN

Now to the economy and the question of its recovery. Recessions are about correcting the spending excesses that have accumulated during the boom and that the central bank's tight money has enforced. Ensuing recoveries are about the economy's rebound from those corrections and monetary loosening by the central bank. These adjustment processes regularly occur in three GDP components in which the boom excesses regularly center: inventories, capital investment, including commercial building, and housing, first leading the downturn and then the upturn. Except for housing, consumer spending rises and falls with the cyclical movement, but far more moderately than these three components.

The following table shows the average pattern of the postwar business cycles in the United States. The first column shows the percentage changes from peak to trough, and the second column shows the percentage changes during the first eight quarters of recovery.

	Downturn	Upturn
Real GDP	-2.0	10.2
Personal consumption	0.7	9.9
Producers' equipment	-10.8	21.4
Nonresidential structures	-4.2	4.8
Residential investment	-10.7	36.7
Real disposable income	0.1	9.0
Real wage and salary income	-2.0	9.0

The important point to see is that consumer spending is definitely not leading.

Between the pattern of the present downturn and the average pattern of past recessions are two main differences. One is the persistent strength of housing, and the other one is a sharper than usual slide in the growth rate of consumer spending, measured from its peak in the second quarter of 2000. Rising house prices and a decline in mortgage rates have clearly played a key role in cushioning the downturn of consumption by offering huge facilities to extract home equity. Rather than curbing his borrowing binge, as in the past, the consumer has stepped it up in order to offset vanishing income growth. Never before has he stretched this far during an economic downturn. But ominously, ever more borrowing has ever less effects on the economy. In this light, the consensus view that the consumer will lead the U.S. economy's recovery is simply absurd.

From Mr. Greenspan's most recent speeches we conclude that he is among the very few who have realized, after all, that this is not the usual garden-variety inventory recession. In his congressional testimony of Jan. 24, he addressed the key problem:

"The dynamics of inventory investment and the balance of factors influencing consumer demand will have important consequences for the economic outlook in coming months. But the broad contours of the present cycle has been, and will continue to be, driven by the evolution of corporate profits and capital investment."

AN ILLUSIONARY INVESTMENT BOOM

We couldn't agree more. This exact observation has been a main theme of our expositions about the U.S. economy ever since 1997, when we first spotted the unusually poor profit performance. Of course, that was also the one sentence in Greenspan's testimony that has been commonly ignored.

Earlier we said recessions are about correcting the excesses of the boom. This begs the question of what have really been the decisive, unsustainable excesses in the U.S. economy during the last boom years that require correction before recovery is possible. The typical key areas of cyclical excess, as just explained, were in inventories, housing and business capital investment.

Popular perception has it that an extraordinary investment boom in the new information technology was the primary force that propelled the boom of the late 1990s. We have vehemently disputed this tale for many years. We have always argued and described in detail that this alleged investment boom was an artifact of government statistics that made economically no sense.

In the fourth quarter of 2000, business investment in computers came to $114 billion, up $34.3 billion between 1997-2000. This is really a small account for Corporate America. But reporting real GDP growth, the Commerce Department used a much higher figure: $317.6 billion, up $214.7 billion between 1997-2000 and accounting for more than 30% of real GDP growth during this period.

Clearly, the boom was only in the latter two figures. The huge difference, as repeatedly explained, arises from a statistical technique called "hedonic pricing." The idea behind this technique is that quality improvements should be treated as price reductions. What the soaring difference in the measurement of computer output and investment in essence reflects is a tremendous surge in computer power since 1995. Manifestly, this hedonic pricing added massively to real GDP growth and implicitly to productivity growth.

For years it has amazed us how little attention has been paid to this statistical practice even by otherwise critical observers. We have always objected to it because it suggests huge increases in spending and revenues of businesses that have never taken place. For the firms, these hedonic dollars are pure statistical fiction, and of course they have no influence on business decisions. On the other hand, these non-existent dollars have played a key role in inflating the real GDP and productivity numbers to those elevated levels that inspired the trash of economic miracles. Take the hedonic pricing away, and the investment boom vanishes before your eyes. The ugly reality, as earlier explained, is net investment at record lows, partly also owing to escalating depreciation charges on increasingly short-lived capital investment.

We believe it is important to recognize this fact because we take note of a widespread perception that this capital spending slump represents largely a correction of former investment excesses. For sure, there were ridiculous excesses in the high-tech sector, but the sector remains a marginal component in the economy, accounting for less than 2% of GDP and little more than 1% of the economy's capital stock. The huge waves that high-tech made in the financial markets were ridiculously out of proportion to its importance in the real economy. To make, in short, the key point: What the capital spending slump reflects is overwhelmingly not the correction of past investment excesses, but a capital spending crisis reflecting a structural profits crisis for which no end is in sight. Corporate America has most assuredly got the message. There's a real disconnect between the corporate response to the development and the bullish perception of consumers and all others.

THE MAIN EXCESS: CONSUMER SPENDING

Looking through the fog of the New Economy hype, there emerges a U.S. bubble economy that has flourished on the back of an unprecedented consumer-borrowing binge. An unusually high rate of personal consumption as a share of GDP since the 1920s is the U.S. economy's key structural problem. This has dramatically worsened in the late 1990s. Consumer spending in these years reached a new high of 80% as a share of nominal GDP, while the share of gross business investment fell to 12%. Net investment was less than 2%.

Pondering the probability of a U.S. recovery, we keep asking ourselves who may actually possess the necessary financial strength to provide the first spending impetus — businesses or the consumer? Since the profits crisis can, in our view, only worsen, we see nothing but protracted weakness ahead for business investment. That leaves us with the consumer as the only alternative. In the bullish litany about the U.S. economy, the borrowing consumer has taken pride of place. High-tech is almost forgotten. The consumer is hailed as the indefatigable borrower and spender who with his brave resilience has crucially tempered the recession, and who will lead the recovery.

It is ludicrous; recessions are always times of correcting borrowing and spending excesses during the prior boom. Mr. Greenspan is desperately trying to prevent any adjustment on the part of the consumer, and that has a compelling reason: his former borrowing and spending excesses are far too big to be corrected by a mild recession.

Looking at the consumer's desolate finances, we see no chance that he is able to embark on a new, persistent borrowing and spending binge, pulling the whole economy forward. Rather, there is an overwhelming risk that he will pull back far more than expected, as proliferating bad news about the economy and corporations will increasingly disillusion him, until his denial finally cracks. To shatter high-riding expectations that have taken root over several boom years, it may need a radically sobering event. We see in this another striking parallel to what happened in 1930.

By no means had the stock market crash in late 1929 in any way encroached upon the prevailing high-riding optimism about the economy. Some formerly critical observers hailed the crash as a healthy correction. Widespread opinion held that any excesses had only been in the market, not in the economy. Virtually nobody, therefore, expected much more than a normal, brief recession. Nobody could possibly have done so. Consumer and business balance sheets were in excellent shape. Consumer installment credit had only just been invented. Business was deteriorating, but it caused little worry because its near-term recovery was generally taken for granted.

But sometime in the fall of 1930, expectations changed dramatically. The precise causes that produced this change in mood are not known. It came approximately one year after the start of the stock market crash, preceding the banking crisis of November-December. The most plausible explanation we have read is a suddenly spreading recognition at the time that the expected recovery had failed to materialize. We have no doubt that this will repeat itself later this year.

THE FIRST PROFITLESS BOOM

Earlier we said that the present plunge in U.S. business capital spending represents basically a crisis in capital formation, rather than a desirable correction of past investment excesses. Stating this, we come to another subject of supreme importance for the assessment of the U.S. economy: *productivity*. It has become the most widely used buzzword about the U.S. economy. In particular Mr. Greenspan makes regular, frequent use of it.

Recent press reports reveal that several members of the Federal Reserve Board were rather critical of him in this respect and the inferences that he drew for monetary policy. One of his contentions was that higher productivity growth, by adding to the supply of goods, allowed him a more tolerant approach to accelerating GDP growth. He even considered it legitimate that the Fed's public emphasis on higher productivity growth would enhance private sector expectations.

In a congressional testimony on July 18, 2001, he said: *"The synergies of key technologies markedly elevated prospective rates of return on high-tech investments, led to a surge in business capital spending and significantly increased the growth rate of structural productivity. The capitalization of these higher expected returns lifted equity prices, which in turn contributed to a substantial pickup in household spending on a broad range of goods and services… The evident attractiveness of investment opportunities in the United States induced substantial inflows of funds from abroad, raising the dollar's exchange rate while financing a growing portion of domestic spending."*

It is fantastic; it is really the ultimate in perverted economic policy and thinking. Mr. Greenspan systematically hypes expectations; the stock market capitalizes them with big gains in equity valuations that augment personal wealth, which, in turn, provides the impetus to higher consumer spending. Obviously, it does not occur to Mr. Greenspan that this is the recipe for a bubble economy that imbalances the resource allocation towards consumption at the expense of investment. For sure, Mr. Greenspan can congratulate himself for his outstanding success in hyping the U.S. stock market and the economy to unprecedented and inconceivable excesses in consumer spending.

There is just one snag: the alleged and reported productivity miracle never delivered the promised profit miracle. The highest stock market valuations went together with the worst profit performance in the whole postwar period, as measured by the government's national income and product accounts. It was the first profitless boom in history. Analysts and investors, however, had a distinct preference for the heavily dressed-up profits that the individual companies report.

BUT WHY?

We have always insisted and explained that the trumpeted productivity miracle could not deliver because it was far more statistical than real. Our disbelief in the productivity hype, however, had still another reason. Actually, we regard this narrow focus on productivity growth as the key ingredient in the economic growth process as a badly flawed approach. In and of itself, productivity growth plays no active role in the economic growth process. Its appearance depends crucially on something else.

This "something else" has the name capital investment. It is the true key ingredient in the growth process, taking care of both demand and supply in the growth process. Capital investment, not productivity, has been the central concern of the old economists. They fully understood the importance of productivity growth, but they regarded it as being chiefly a function of the level of capital investment. Traditional economic growth theory is about changes in the allocation of resources. Where there is high net capital formation, high productivity growth can be taken for granted. Conversely, where there is low net capital formation, productivity growth will be lagging. A nation's wealth comes from one single source: productive investment of its savings into profitable enterprise. Looking at the U.S. economy's poor and declining net investment ratio and almost nonexistent saving, it was always clear to us that the widely trumpeted productivity miracle must be another mirage.

Capital investment, in fact, is the critical mass in the economic growth process generating all the effects that make for rising wealth and rising living standards. While the capital goods are produced, capital investment increases demand, employment, incomes and tangible wealth. And once these capital goods are installed, they increase supply, productivity, employment and income. It is necessary to see the whole.

All this leaves us with the pertinent question of the cause or causes of this unusually poor profitability of the U.S. economy already during the boom years. Here, too, we can only repeat what we have reasoned many times before: This generally poor profitability arises ultimately from the anomalies in the American equity culture. According to Wall Street mantra, the imperative imposed on corporations to maximize profits makes for unprecedented efficiency. Thinking it all through from a macro perspective, we regard the particular corporate strategies that have developed in the frenetic pursuit of quick profit maximization as outright injurious to overall profits. Announcements of mergers, acquisitions and cost cutting have been grist to the mill of the bullish Wall Street crowd. But this micro logic overlooks that all these transactions and measures add nothing at all to overall wealth and revenues. By "crowding out" new capital formation, they diminish overall wealth and rates of return.

CONCLUSIONS

The world should be prepared for the deepest and most intractable recession of the whole post-World War II period in the United States, with no natural process of recovery in prospect.

What the optimists have lost sight of is that this U.S. recession was caused neither by tight money, like every previous recession, nor by the events of Sept. 11. The root cause of this recession is that the world's biggest economic and financial bubble has burst of its own accord.

In recent months, bounce-back effects from the sharp reactions to the Sept. 11 terrorist attacks have temporarily given a better look to U.S. economic data. But recession is sure to reassert itself. The key to economic performance is profits and their impact on investment spending, but our analysis of profit sources suggests that their decline will accelerate. Its causes are structural, not cyclical.

Careful analysis of the underlying forces and influences leads us to the conclusion that capital investment, both in plants and equipment, exports and even housing will weaken during the first half of 2002. These are the crucial demand components that regularly propel recoveries.

There is a general, comforting perception that the plunge of high-tech equities has corrected and eliminated the main part of the bubble. No, the unsustainable bubble-related, unsustainable imbalances are everywhere in the economy and the financial system. To mention just the most visible ones: near-zero personal saving implying unsustainable consumer spending, the huge trade deficit implying a highly vulnerable dollar and monstrous leverage in the credit markets.

There is but one thing between the present stability and the bursting of all these bubbles — that is a pervasive sense of denial.

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